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# In the Supreme Court of the United States

OCTOBER TERM, [illegible]

MARGARET PUTNAM, ET AL., PETITIONERS

v.

J. JOHN BRUCE, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE [illegible] CIRCUIT

BRIEF FOR THE OPPOSITION AND CONDITIONAL CROSS-PETITION AS AMICUS CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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# In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 908

MANAGED FUNDS, INC., PETITIONER

*v.*

J. JOHN BROUK, ET AL.

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

## BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

### OPINIONS BELOW

The opinion of the court of appeals (Pet. 29–64) is reported at 286 F. 2d 901. The order of the district court is unreported.

### JURISDICTION

The judgment of the court of appeals was entered on January 13, 1961. The motion for rehearing was denied on March 6, 1961. The petition for a writ of certiorari was filed on May 8, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

### QUESTION PRESENTED

Whether a private right of action will lie for violation of the Investment Company Act of 1940.

## STATUTE INVOLVED

Pertinent sections of the Investment Company Act of 1940, 15 U.S.C. 80a–1, *et seq.*, are reproduced in the appendix to the petition, pp. 67–73.

## STATEMENT

Petitioner, Managed Funds, Inc., is an open-end investment company[1] registered under the Investment Company Act of 1940 (hereinafter referred to as "the Act"). Managed Funds filed a complaint on May 29, 1959, and an amended complaint on October 23, 1959, in the United States District Court for the Eastern District of Missouri seeking an accounting, injunctive relief, and money damages from its former directors, its investment advisers, Slayton Associates, Inc., and one Jaquith, its brokers, Model, Roland & Stone, and others (see Pet. 6) for alleged violations of the Act.[2]

The complaint alleges that Managed Funds contracted with Slayton Associates, Inc., to act as its investment adviser for an annual fee of ½ of 1% of the value of Managed Funds' assets (R. 4, 14); that

[1] Section 5(a)(1) of the Act (15 U.S.C. 80a-5(a)(1)) defines an open-end investment company as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer."

[2] Josephson, a shareholder of Managed Funds, had previously filed a derivative action in the District Court for the District of Delaware in which he requested the same relief as that requested in the action initiated by Managed Funds. The Josephson action was subsequently transferred to the Eastern District of Missouri and consolidated with the Managed Funds action.

Respondents in this Court are the so-called "independent" directors of Managed Funds. The other defendants did not appeal, and therefore the action as to them is still pending in the district court.

Slayton Associates accepted fees at that rate, totalling over $1,000,000 over a six-year period, for which it performed no services, having delegated to Jaquith its duties as investment adviser to Managed Funds (R. 5, 15, 16); that Jaquith agreed to perform these duties for a minimum compensation of $50,000 a year for five years beginning in 1953 and a minimum of $35,000 a year for the next succeeding five years, payment to be effected through brokerage on Managed Funds' portfolio transactions (R. 5, 15); that Jaquith channeled Managed Funds' brokerage business to Model, Roland & Stone, a brokerage partnership of which Jaquith was a member, and that the partnership received brokerage commissions of more than $1,500,000 (R. 5); that Jaquith and Model, Roland & Stone paid in excess of $50,000 a year to each of two named individuals (one is a former director of Managed Funds and the other is a brother-in-law of Hovey E. Slayton, an officer of Slayton Associates) for which no services were performed (R. 5).

The complaint further alleges that Managed Funds' investment policy as announced in its prospectuses was to provide capital growth, as well as reasonable income consistent with such a growth policy (R. 4); that, after the arrangement was entered into with Jaquith, this policy was not followed, but distributions to shareholders of a predetermined income were made; that to make such distributions capital gains had to be realized; that this was accomplished by excessive portfolio transactions; that Jaquith and his partners in Model, Roland & Stone thereby made greater commissions and the fund sold

many of its best capital growth holdings, which in a number of instances were immediately repurchased at a higher price (R. 5, 6, 16).

The complaint also alleges that Managed Funds may be liable to purchasers of its shares by reason of the false statements contained in Managed Funds' registration statements; that stop order proceedings against Managed Funds have been instituted by the Securities and Exchange Commission as a result of those false statements and that Managed Funds was thereby damaged (R. 6–8). The complaint alleges finally that Slayton Associates, Jaquith, and Model, Roland & Stone occupied a fiduciary relation to Managed Funds which relation was breached through mismanagement and waste of Managed Funds' assets (R. 9, 10, 19); and that the "independent" director defendants of Managed Funds had knowledge both of this fiduciary relation and of the mismanagement and waste, but failed to take any action to prevent it (R. 6, 10).

The district court denied the defendants' motions to dismiss. On appeal under the interlocutory appeals statute (28 U.S.C. 1292(b)) to the United States Court of Appeals for the Eighth Circuit, the judgment of the district court was reversed on the ground that the Investment Company Act provides for no civil remedies. A petition for rehearing was denied by the court of appeals. A motion of the Securities and Exchange Commission requesting leave to file a memorandum as amicus curiae on the rehearing was also denied.

## REASONS FOR GRANTING THE WRIT

1. This case raises a question of great public importance—whether the Investment Company Act by implication gives rise to a right of action by shareholders of investment companies for violation of the Act. As of March 30, 1961, the open-end investment companies, generally referred to as "mutual funds," alone had over five million shareholder accounts totaling approximately 19½ billion dollars in net asset value. The average account was less than $3,900. Congress stated in the Investment Company Act that certain investment company practices adversely affect the national public interest as well as the interests of investors, including as one such practice: "when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers * * * [or] in the interest of underwriters, brokers, or dealers, * * * rather than in the interest of all classes of such companies' security holders" (Section 1(b), 15 U.S.C. 80a–1(b)).

The complaint in this case allages in detail that an investment company, which is registered and covered by the Investment Company Act, has been operated and managed in the interest of its directors, officers, investment advisers and brokers rather than in the interest of its security holders. Despite these allegations that respondents have violated the duties and standards prescribed in the Act, the court below held that the federal courts did not have jurisdiction to provide a remedy. Thus, the holding below would

deprive investment company shareholders of virtually any remedy under the Investment Company Act.

Moreover, the decision below will have a broad impact on presently pending litigation. There are approximately fifty suits now pending in various state and federal courts involving eighteen registered investment companies. Approximately twenty of the suits which are pending in federal courts raise the question of whether a right of action flows from violation of the Act. Some of the state court actions also raise this federal problem. The numerous cases now pending in the lower courts make an early resolution of this issue in this Court highly desirable.

2. The decision below is in conflict with the principles enunciated in numerous courts of appeals' decisions under the other federal securities laws. The courts of appeals have repeatedly sustained an implied private right of action for violation of the provisions of the Securities Exchange Act of 1934. Section 6(b): *Baird* v. *Franklin*, 141 F. 2d 238, 245 (C.A. 2). Section 10(b): *Slavin* v. *Germantown Fire Ins. Co.*, 174 F. 2d 799 (C.A. 3); *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (C.A. 2); *Fratt* v. *Robinson*, 203 F. 2d 627 (C.A. 9); *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808 (D. Del.), affirmed, 235 F. 2d 369 (C.A. 3); *Errion* v. *Connell*, 236 F. 2d 447 (C.A. 9); *Matheson* v. *Armbrust*, 284 F. 2d 670 (C.A. 9); *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5); *Reed* v. *Riddle Airlines*, 266 F. 2d

314, 315 (C.A. 5).[3] Similarly in *Goldstein* v. *Groesbeck*, 142 F. 2d 422, certiorari denied, 323 U.S. 737, the Second Circuit upheld a private right of action involving the application of provisions in the Public Utility Holding Company Act of 1935 similar to those in the Investment Company Act involved in this case.[4] In these holdings, the courts of appeals have followed the decisions of this Court (in cases not involving securities statutes) that private rights of action flow from violation of a federal statute in favor of those whom the statute is designed to protect.[5] We submit that these private rights of action

[3] The only court of appeals' decision suggesting the contrary is *Howard* v. *Furst*, 238 F. 2d 790 (C.A. 2), involving Section 14 of the 1934 Act. This case is distinguished on several grounds in *Brown* v. *Bullock* (S.D.N.Y.), decided March 9, 1961, now pending an appeal before the Court of Appeals for the Second Circuit (copies of which we have filed with the clerk). See opinion, pp. 46–51.

[4] The court below purported to distinguish *Goldstein* by pointing out that in the instant case the defendant directors did not profit and were not in privity of contract (Pet. 54–56), but this was also true as to the director defendants in *Goldstein*. The invalid contracts in that case were between the holding company defendants on the one side and four operating companies on the other and the profit went to the two corporate defendants. See also *infra*, p. 13.

[5] See, *e.g.*, *Texas & Pacific Ry Co.* v. *Rigsby*, 241 U.S. 33, 39; *Bell* v. *Hood*, 327 U.S. 678, 684; *A. C. Frost & Co.* v. *Coeur D'Alene Mines Corp.*, 312 U.S. 38, 43; Restatement of the Law of Torts, § 286. In the *Texas & Pacific* case this Court stated: "A disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied * * *" (241 U.S. at 39). In *Bell* v. *Hood*, the Court

are especially appropriate in the investment company area because of the great measure of trust and confidence necessarily involved in the investor's relations with his company's management. The reasoning which underlies the implication of private rights of other federal securities law provisions thus applies with redoubled force to violations of the Investment Company Act.

The decision below is directly in conflict with several holdings of the district courts that the Investment Company Act gives rise to an implied private right of action. *Brown* v. *Bullock, supra;* * *Schwartz* v. *Bowman,* 156 F. Supp. 361 (S.D. N.Y.), appeal dismissed on other grounds *sub nom. Schwartz* v. *Eaton,* 264 F. 2d 195 (C.A. 2); *Cogan* v. *Johnston,* 162 F. Supp. 907 (S.D. N.Y.); see also *Taussig* v. *Wellington Fund,* 187 F. Supp. 179 (D. Del.); *Breswick & Co. v. Briggs,* 136 F. Supp. 301 (S.D. N.Y.). In *Brown* v. *Bullock,* the district court specifically refused to follow the decision below. Moreover, in *Schwartz* v. *Eaton,* the court of appeals commented favorably upon the district court's determination in

held that: "* * * where federally protected rights have been invaded, it has been the rule from the beginning that courts will be alert to adjust their remedies so as to grant the necessary relief" (327 U.S. at 684).

* This case was argued before the Second Circuit sitting *en banc* on May 22, 1961, and is awaiting decision.

that case sustaining an implied federal private right of action under the Investment Company Act.[7]

3. The court of appeals clearly erred in holding that the Investment Company Act is not properly construed to provide for a private right of action. Section 1 of the Act makes plain that Congress designed the Act for the protection of the investing public. Then, Section 44 of the Act (15 U.S.C. 80a–43) provides that "[t]he district courts of the United States * * * shall have jurisdiction of * * * all suits in equity and actions at law brought to enforce any liability or duty created by" this Act and that such suits or actions can be brought "in the district wherein the defendant is an inhabitant or transacts business." An identical provision was relied upon in *Goldstein* v. *Groesbeck, supra,* by the Second Circuit in holding that a private right of action was created by the Public Utilities Holding Company Act for violation of the duties imposed by that Act.

The complaint here plainly alleges violations of duties imposed by the Investment Company Act. First, Section 15(a) of the Act (15 U.S.C. 80a–15(a))

[7] The court of appeals said (264 F. 2d at 196): "In a reasoned decision * * * the district court held that the complaint * * * stated a claim under the Investment Company Act upon which relief can be granted." The court of appeals also stated (*id.* at 198, note 5): "That such remedies may be had under the Investment Company Act is made clear by the earlier part of Judge Dimock's decision, D.C. S.D.N.Y., 156 F. Supp. 361; and see *Brenwick & Co.* v. *Briggs*, D.C. S.D.N.Y., 136 F. Supp. 301; *Cogan* v. *Johnston*, D.C. S.D.N.Y., 162 F. Supp. 907." The issue before the Second Circuit involved other portions of Judge Dimock's decision.

makes it unlawful for any person to act as investment adviser of a registered investment company unless the contract has been approved by a majority of the shareholders of the company, and requires that the contract must provide "for its automatic termination in the event of its assignment by the investment adviser." Section 15(c) of the Act (15 U.S.C. 80a–15(c)) makes it unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract whereby a person undertakes to act regularly as an investment adviser unless the contract is approved either by a majority of the "independent" directors or a majority of shareholders. Moreover, Section 47 of the Act (15 U.S.C. 80a–46) renders void any contract which violates Section 15. Thus, the Investment Company Act clearly imposes a duty on directors of investment companies not to enter contracts offending Section 15—a duty which Section 44 states is enforceable in the federal courts.[9]

The complaint here alleges that respondents violated their duties under Section 15 of the Act. The initial advisory contract between Managed Funds and Slayton Associates was approved by Managed Funds' stockholders. The complaint states, however, that the contract of Managed Funds with Slayton Associates was automatically terminated by the assign-

[9] Section 15 is analyzed at considerable length in *Brown* v. *Bullock*, *supra* (see opinion, pp. 52–57). That opinion goes on to demonstrate that the Act makes directors liable for gross misconduct or abuse of trust (see opinion, pp. 57–78).

ment of the contract to Jaquith as provided in Section 15(a) and that no contract for Jaquith to act as investment adviser was ever approved by the stockholders of Managed Funds as Section 15(a) also requires (R. 7, 16). Nevertheless, the complaint alleges, Managed Funds' contract with Slayton Associates, Inc., was renewed by defendant directors, including respondents, who, as independent directors, had under Section 15(c) a particular responsibility in this matter. Moreover, the complaint claims, not merely that respondents had violated their fiduciary duty by failing to prevent Managed Funds from operating and making large payments (over 2½ million dollars) over a five-and-a-half-year period pursuant to void contracts (the 1 million dollars to Slayton Associates was also for services which were not performed), but that they knowingly approved of these actions (R. 6, 10).

Second, the complaint charges respondents with violation of their fiduciary duties under Sections 8(b) (15 U.S.C. 80a-8(b)) and 13(a) (15 U.S.C. 80a-13(a)) of the Act. Section 8(b) provides that registered investment companies must file with the Commission a registration statement including recitals of policy which the registrant deems fundamental. Section 13(a) provides that a registered investment company cannot "deviate from any fundamental policy recited in its registration statement pursuant to" Section 8(b).

The complaint in this case alleges that Managed Funds, in accordance with Section 8(b) of the Act, stated in its registration statements that its policy

was to provide for "capital growth" and, consistent with this policy, to seek reasonable income, the net investment income and any realized profits on the sale of securities to be distributed quarterly (R. 4). The complaint states that, after Jaquith became investment adviser to Managed Funds, the policy of capital growth was not followed. Instead, the policy was adopted of maintaining a predetermined amount of distributions and, if the investment income was insufficient, to realize capital gains from the sale of securities (R. 5–6). The result, the complaint says, was to "churn" Managed Funds' portfolio to the benefit of the defendant brokers and to the great loss of the Funds' portfolio (R. 6, 16, 17). The complaint further alleges that respondents, as directors of Managed Funds, had a fiduciary duty not to permit a deviation from the Funds' fundamental policy without the approval of a majority of shareholders, but that, instead, respondents knowingly participated in this plan (R. 6–7).

4. The court of appeals suggested two considerations in this case making an implied right of remedy particularly inappropriate. First, the court said that petitioners sought to make respondents absolute insurers (Pet. 64). In fact, however, the complaint charges respondents with knowledge of the violations of the Act. And, in any event, even if no actual knowledge were alleged, fiduciaries are often charged with violation of their fiduciary duties—whether in-

posed by common law or by statute—because of their failure to discover facts detrimental to the beneficiaries and to remedy the situation.

Second, the court emphasized that no privity of contract exists between the plaintiffs and defendants (Pet. 43). In fact, however, privity of course existed between Managed Funds, one of the plaintiffs, and its own directors. But, regardless, privity "is not a fixed condition precedent to the implication of a private remedy for a statutory violation that injured the plaintiffs, members of the protected class. * * * [Privity] is an evidentiary fact to be considered in conjunction with other material facts in determining whether the relationship (such as it is) between the plaintiffs and the defendants and the nature of the particular acts and transactions involve the duty created by the statute." *Brown* v. *Bullock, supra* (see opinion, p. 42).

In short, the complaint charges the respondents with knowing of, and indeed participating in, operations by Managed Funds which clearly violated provisions of the Investment Company Act and which resulted in great detriment to Managed Funds and its shareholders. We submit that, if the petitioners can prove their allegations, they will have made out a valid case under Section 44 of the Act.

## CONCLUSION

For the foregoing reasons, we respectfully submit that the petition for a writ of certiorari should be granted.

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